VZCZCXYZ0001
PP RUEHWEB

DE RUEHHK #1683/01 2461026
ZNY CCCCC ZZH
P 031026Z SEP 09
FM AMCONSUL HONG KONG
TO RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHC/SECSTATE WASHDC PRIORITY 8465
INFO RUEHOO/CHINA POSTS COLLECTIVE
RUEHGP/AMEMBASSY SINGAPORE 4126

C O N F I D E N T I A L HONG KONG 001683

SIPDIS

STATE FOR EAP/CM AND EEB/IFD/OMA

E.O. 12958: DECL: 09/02/2034
TAGS: EFIN ECON PGOV HK
SUBJECT: WINNERS AND LOSERS IN HONG KONG'S LEHMAN MINIBONDS
SETTLEMENT

REF: A. HONG KONG 167
¶B. HONG KONG 63
¶C. 08 HONG KONG 2183
¶D. 08 HONG KONG 2027

Classified By: Acting Consul General Chris Marut, Reason 1.4 b/d

¶1. (C) Summary: A July agreement between 16 Hong Kong banks and the Hong Kong Securities and Futures Commission (SFC) to offer compensation to most Lehman Bros, minibond investors in Hong Kong has been criticized for allowing banks accused of mis-selling to avoid criminal prosecution, but has been overwhelmingly accepted by investors. Several weeks before the October deadline for responding to the deal, close to 60 percent of eligible investors have agreed to the banks' offer to buy back minibonds at 60-70 percent of their face value. Hong Kong officials believe the settlement offer is generous to investors and will resolve a contentious political problem. The SFC compelled reluctant banks to come to the negotiating table by threatening to revoke their licenses to sell securities. But the key to the settlement may have been agreement by Bank of China Hong Kong (BOC HK) to compensate investors. Approval from Beijing broke the logjam and pressured the other banks to join the agreement, say local sources. The HKG is considering significant reforms to increase oversight, tighten restrictions on financial product sales and create additional channels to protect consumers. End Summary

¶2. (C) Comment: This deal is good for minibond investors, who faced a long and uncertain process to claim the value of the minibonds' underlying assets. The Tsang administration's public demand that banks compensate Lehman minibond buyers meant their credibility hinged on efforts to get investors money back, rather than on their support for the legal process. This outcome resolves the HKG's immediate problem as public criticism should diminish significantly. However, its heavy-handed tactics in dealing with the banks undermine due process and won't help Hong Kong's long-term competitiveness. The HKMA's reputation as Hong Kong's premier financial regulator has taken a blow, as LegCo members and the public assign much of the blame for bank misbehavior to lax HKMA oversight. The SFC's negotiations with the banks were acrimonious, but the SFC victory will strengthen their regulatory credibility and may lead to additional transparency requirements in the equities market. The 16 minibond-selling banks will have to increase provisions to buy back these products, but profits at all Hong Kong banks will be squeezed as the industry will be subject to stricter oversight of investment product marketing. End Comment.

The Minibond Deal is Done

¶3. (C) After months of negotiations, the Hong Kong SFC, the HKMA and 16 Hong Kong banks announced a deal July 22 to allow most purchasers of Lehman Bros, minibonds (high-risk credit linked derivatives) to sell these products back to the banks where they were purchased for 60 percent of their face value. Purchasers over 65 years of age can receive 70 percent of the face value. The offer is limited to non-professional investors. If banks are able to recoup any of the underlying collateral, an additional payment of 10 percent will be disbursed to minibond investors. If more than 70 percent of the underlying value of the minibonds is recovered by the banks, they will pay the excess to eligible investors. In addition, banks agreed to immediately implement special procedures for complaints related to the sale of structured products. Banks will submit to an independent review of their processes related to the sale of structured products and the handling of complaints and implement any recommendations. In return, all investigations of bank mis-selling (i.e., misleading investors, failing disclose risk, or selling to inappropriate customers) connected to the sale of these products will be dropped. Qualified investors have 60 days from the date of receiving a repurchase order from the banks to accept or decline. As of August 27, 14,935 of approximately 25,000 eligible investors have responded, with virtually all (14,806) accepting the offer. While some are expected to reject the settlement, government officials expect almost all will eventually agree.

¶4. (C) The government believes the settlement is a good one for investors and for Hong Kong. Hong Kong Monetary Authority (HKMA) Executive Director for Banking Supervision Nelson Man praised the agreement for resolving a contentious

political issue for the government and for being extremely generous to investors, who would be unlikely to recover as much through individual lawsuits. SFC Executive Director Mark Steward noted that banks are much better placed to recover the value of underlying assets and predicted high recovery rates. Financial Service and Treasury (FSTB) Undersecretary Julia Leung noted that SFC, in its role as the securities industry regulator, led the negotiations with the banks. Initially, the SFC was too demanding, pursuing 100 percent compensation for minibond purchasers, in addition to fines, said Leung. FSTB wanted a broad solution that could be accepted by all sides, and instructed the SFC that statutory remedies, including fines, would not resolve the government's political problem. Dropping the investigations of banks accused of mis-selling minibonds was necessary to get banks to agree to the deal, said Leung. HKMA investigation of the more than 21,000 complaints had found few merited additional legal action.

====================================
SFC Squeezes Bank of China Hong Kong
====================================

¶5. (C) The negotiations between the SFC and the banks were acrimonious. "The banks were in denial," said Steward. But they had to come to an agreement, or face the prospect of the SFC revoking their licenses to sell securities. Banks understand now that they have to deal with the SFC, said Steward. "This is a watershed for the banking industry in Hong Kong," he said. Leung confirmed that the government had threatened the banks with securities license revocation and fines if there were no settlement. But the key to reaching an acceptable compromise was BOC HK's offer of 60-70 percent compensation, said Leung. Over half of the minibond sales were through BOC HK branches, but the bank was reluctant to settle without approval from Bank of China headquarters in Beijing, she said. FSTB raised the issue with Mainland counterparts on several occasions. Once the Mainland bank agreed, the others quickly fell into line, said Leung. Despite the contentious discussions, banks have publicly supported the repurchase scheme. However, the banks were not happy with the settlement or the process, according to HKMA's Man. The banks distrust the SFC and prefer that the HKMA retain its role as their primary regulator.

¶6. (C) The settlement not only resolves a political problem for the HKG, it changes the relationship between the banks and Hong Kong regulators. Previously, banks met regularly with HKMA regulators, but their primary interaction with the SFC was their request for SFC approval of investment marketing literature. However, beginning in February 2009 the SFC has required banks to record conversations and separate banking and investing service centers in branches to avoid confusing customers. Under terms of the settlement, the SFC and the HKMA are jointly requiring banks to streamline their investment sales and complaint procedures and banks are now improving audits and keeping better records. Banks are requiring lengthy risk counseling and assessments before selling new or risky investment products like renminbi bonds, in anticipation of future HKMA and SFC requirements which remain unclear.

=======================================
Moral Hazard Risks and Upcoming Reforms
=======================================

¶7. (C) The settlement scheme does increase investor moral hazard in Hong Kong, said Man. The scheme applies only to Lehman Bros, minibonds and not to similar products sold by other institutions. Dissatisfied investors in other structured products (of which there are many in Hong Kong) may be more inclined to take their complaints to the streets, rather than the courts, he said. Improved sales and complaint procedures should address some of those concerns. The scheme, however, is an imperfect compromise.

¶8. (C) The deal further widens the gap between Hong Kong's principles-based market supervision and rules-based enforcement frameworks, said Man. Hong Kong is now considering limiting investor access to some products without safeguards. The SFC has proposed requiring investment banks to provide on-going risk assessments, i.e., informing investors when a product in their portfolio has been downgraded. According to Leung, the FSTB is considering creating a financial ombudsman, based on the UK model, who will address consumer complaints. The FSTB is also considering creating a formalized Investor Education Council to promote financial literacy. Finally, as part of its

response to the global financial crisis, Hong Kong is reviewing its dual regulatory structure (with HKMA overseeing banking and SFC supervising investments), with some advocating a single regulator (the HKMA) overseeing both banking and investments. These proposals are currently under discussion within the government, said Leung, but there are no plans to formally consult with the private sector.
MARUT